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No. 74-1042

In the Supreme Court of the United States

OCTOBER TERM, 1975

ERNST & ERNST, PETITIONER

v.

OLGA HOCHFELDER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

ROBERT H. BORK,
Solicitor General,

DANIEL M. FRIEDMAN,
Deputy Solicitor General,
Department of Justice,
Washington, D.C. 20530.

LAWRENCE E. NERHEIM,
General Counsel,

PAUL GONSON,
Associate General Counsel,

CHARLES E. H. LUEDDE,
Special Counsel,

THEODORE L. FREEDMAN,
JOHN M. MAHONEY,
Attorneys,
Securities and Exchange Commission,
Washington, D.C. 20549.

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

This brief is filed pursuant to the Court's invitation of April 14, 1975.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A) is reported at 503 F.2d 1100. The opinion of the district court (Pet. App. B) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on August 30, 1974, and a petition for rehearing

was denied on November 22, 1974. The petition for a writ of certiorari was filed on February 20, 1975, and was granted on April 14, 1975. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, 17 C.F.R. 240.10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

QUESTIONS PRESENTED

The Securities and Exchange Commission will discuss the following questions:

1. Whether an accountant's negligent preparation and certification of a financial statement which facilitates another's violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder is sufficient to establish a violation of Rule 10b-5 by the accountant.

2. Whether, if question 1 is answered affirmatively, a plaintiff in a private action seeking to recover money damages based upon the accountant's negligent violation of Rule 10b-5 must also establish (i) that the accountant knew or could reasonably foresee that the financial statement would induce the plaintiff to enter into the transaction involved in the suit, (ii) that the plaintiff relied upon the fi-

nancial statement, and (iii) that the amount of plaintiff's damages caused by the accountant's negligence is definite and ascertainable.

STATEMENT

From 1946 through 1967 the petitioner, Ernst & Ernst, an accounting firm, was retained by First Securities Company of Chicago, a Chicago stock brokerage firm ("First Securities"), to perform annual audits of First Securities' books and records. In connection with these audits Ernst & Ernst prepared for First Securities Forms X-17A-5, which were required to be filed annually by First Securities with the Commission pursuant to Commission Rule 17a-5, 17 C.F.R. 240.17a-5. Form X-17A-5 is the form prescribed for annual reports of brokers' financial conditions.[1] The rule required that the Forms X-17A-5 include a certificate which stated "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." (App. 157.)

As First Securities' auditor, Ernst & Ernst was required by the rule to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." The rule provided that

[1] In 1975 Section 17 was amended to require brokers to send annual certified financial statements to their customers. See Section 17(e)(1)(B) of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 139.

nothing in it should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions" required by the rule (App. 156).

Respondents filed suit for damages in 1971 in the United States District Court for the Northern District of Illinois under Section 10(b) of the Securities Exchange Act of 1934 (App. 1, 3). The complaints alleged that respondents were securities customers of First Securities, and that they were induced by Leston B. Nay, the president and owner of 92 percent of the stock of First Securities, in some cases as early as 1942, to invest "in a fictitious and non-existent escrow" account managed by Nay (App. 3).[1a] In June 1968, Nay committed suicide, and in a suicide note revealed the existence of the "escrow operation" (App. 3,399).

The theory of the complaint was that "Ernst & Ernst failed to exercise proper or appropriate auditing procedures" in its audits of First Securities and that this failure resulted in Ernst & Ernst's failure to discover certain practices of First Securities, the discovery of which would have led to the discovery of Nay's fraudulent escrow operation (App. 13). These practices included the facts that "Nay * * * took no regular vacations" and that Nay concealed his fraudu-

[1a] Nay is alleged to have "converted * * * to his own use immediately on their receipt" the funds invested in the escrow account (App. 3).

lent activities, in part, through the requirement that all mail addressed to Nay at First Securities, or addressed to First Securities to the attention of Nay, could not be opened by anyone other than Nay (*ibid.*). If Nay were absent from the firm for several days, all mail addressed to him would be left unopened on his desk (*ibid.*).

Respondents contended that had Ernst & Ernst conducted a proper audit of First Securities, it would have discovered Nay's mail rule; that the existence of that rule would have had to have been reflected in the Forms X-17A-5 filed by First Securities, which in turn would have led to an investigation of Nay by the Commission, the Midwest Stock Exchange, or the National Association of Securities Dealers; and that the investigation would have revealed the fraudulent escrow operation (App. 77-78, 84-85).

The complaint charged that Nay's "fraud" violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission (App. 11), and that Ernst & Ernst aided and abetted Nay's violations by its "failure" to conduct a proper audit (App. 15).

After discovery, the district court granted Ernst & Ernst's motion for summary judgment and dismissed the action (Pet. App. 40a). The court held, *inter alia*, that while Ernst & Ernst "could be held liable on one or more legal theories for any negligence in auditing First Securities," there was no evidence that Ernst & Ernst had been negligent in auditing First Securities or in failing to discover the mail rule (*id.* at 39a-40a).

The court of appeals reversed and remanded, holding (Pet. App. 4a) that

> where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.

The court of appeals reasoned that there were questions of fact whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule constituted a breach of its duty as an auditor to investigate First Securities' system of internal accounting control (*id.* at 18a); and whether "adequate inquiry and subsequent disclosure on Ernst & Ernst's part would have led to the discovery or prevention of Nay's fraud" (*id.* at 25a).

SUMMARY OF ARGUMENT

I

Negligent as well as intentional misconduct can violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The victims of

manipulative and deceptive securities practices are equally injured by intentional and by negligent conduct. The congressional purpose in Section 10(b) of protecting investors against such practices therefore requires that negligent as well as intentional conduct can violate the section. Petitioner itself recognizes that in enforcement proceedings brought by the Commission, negligent conduct can violate the statute and rule. The determination whether particular conduct constitutes such a violation, however, should not depend upon the identity of the plaintiff.

Since the respondents were the victims of an intentional securities fraud perpetrated by Nay, the threshold question in this case is whether Ernst and Ernst's alleged negligence in conducting the audit, which facilitated the concealment of that fraud, violated Section 10(b) and Rule 10b-5. Although respondents' complaints characterize Ernst and Ernst as an "aider and abettor" rather than a direct participant in the fraud, Ernst and Ernst's negligence, if established, would constitute a violation of Rule 10b-5.

II

Although negligent conduct may violate Rule 10b-5, it does not follow that every negligent violation of the Rule gives rise to money damages. The private right of action to recover damages for violation of Rule 10b-5 is a judicially created remedy, designed to further the purposes of the federal securities laws. In determining whether damages should be awarded for a particular violation of Rule 10b-5, the limitations upon damage liability that Congress imposed in those

sections of the federal securities laws that expressly provide for private damage suits for violations of those laws constitute an appropriate guideline for the courts in determining the scope of the implied action under Rule 10b-5.

These express civil remedies permit a plaintiff to recover for negligent conduct only in circumstances where (i) the defendant knew or could reasonably foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable. The same limitations should be applied to damage actions under Rule 10b-5 where the defendant's conduct was negligent.

III

The present record does not establish those conditions. Since Ernst & Ernst was not even aware of Nay's escrow account, it could not have known or foreseen that respondents would rely upon its financial statements in investing in that account; respondents in fact did not rely upon it; and the amount of respondents' damages resulting from their investments in the account was unascertainable. The theory the Commission here urges, however, was not presented to the lower courts, and respondents may be contending that Ernst & Ernst's conduct was reckless or intentional rather than merely negligent. If the Court agrees with our submission, it should therefore remand the case to the district court to enable that court to consider any proposed amendment of the complaints to reflect this theory.

ARGUMENT

I. SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5 OF THE SECURITIES AND EXCHANGE COMMISSION SUPPORT A PRIVATE ACTION AGAINST AN ACCOUNTANT BASED UPON THE ACCOUNTANT'S NEGLIGENT PERFORMANCE OF HIS WORK

The threshold issue in this case is whether in a private action for damages an accountant may be held to have violated Section 10(b) and Rule 10b-5 as a result of the accountant's negligent performance of his work.[2] The court of appeals recognized that such an action may be maintained. The petitioner and the *amicus* American Institute of Certified Public Accountants ("AICPA") contend that those provisions prohibit only intentional and willful, but not negligent conduct, and, accordingly, that the implied private right of action under Rule 10b-5, which this Court recognized in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n. 9, and

[2] Private actions by the victims of securities frauds are a "necessary supplement" to the Commission's enforcement activities. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. Moreover, the answer to this initial question may have some bearing upon the Commission's ability effectively to exercise its enforcement responsibilities under the federal securities laws; in particular under Section 21(d) of the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 154-155, which authorizes it to obtain "a permanent or temporary injunction or restraining order" against any person who "is engaged or is about to engage in acts or practices constituting a violation of any provision of [the Act], the rules or regulations thereunder * * *."

Blue Chip Stamps v. *Manor Drug Stores*, No. 74-124, decided June 9, 1975, slip op. p. 6, must be similarly so limited. We submit, however, that Section 10(b) covers negligent as well as intentional conduct and that in Rule 10b-5 the Commission has proscribed negligent conduct.

A. Section 10(b) of the Act Prohibits Negligent Conduct

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), makes it unlawful for any person to employ, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance" in contravention of the rules of the Commission. There is nothing in this broad language that limits its prohibition to "manipulative or deceptive" practices that are done intentionally. In view of the congressional purpose in the legislation to provide investors with the broadest possible protection against false and deceptive practices that may injure them,[3] we submit that Congress intended Section

[3] *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151; *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433; *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195.

This Court has previously recognized in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 468, that the scope of Section 10(b) and Rule 10b-5 are not affected by the fact that certain conduct which falls within their purview may also be proscribed by another provision of the federal securities laws. The Court stated "[t]he fact that there may well be some overlap [between the two sections] is neither unusual nor unfortunate" (*ibid.*).

10(b) to bar all such practices and not just those done intentionally. The adverse effect of manipulative or deceptive practices upon investors is no less when they result from negligence than when they are done intentionally.

Where Congress intended to limit the reach of the Act to willful conduct—both with respect to the violations themselves and to civil liability by violators—it specifically said so. Thus Section 9(a)(1) and (2) of the Act, 15 U.S.C. 78i(a)(1) and (2), prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security * * * or * * * with respect to the market for any such security," or "for the purpose of inducing the purchase or sale of such security by others." It also prohibits (Section 9(a)(4), 15 U.S.C. 78i(a)(4)) a broker or dealer, "for the purpose of inducing the purchase or sale of such security," from making any false or misleading statement "which he knew or had reasonable ground to believe was so false or misleading." Section 9(e), 15 U.S.C. 78i(e) imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of Section 9 liability to anyone who purchased or sold a security at a price which was affected by the manipulative activities.

The legislative history of the Act confirms that the broad language of Section 10(b) is not limited to intentional acts. Congress was informed that "in modern society there are many things you have to

make crimes which are sheer matters of negligence," [4] and that "intent is not necessary for every crime." [5] Moreover, this history shows that Congress intended Section 10(b) to give the Commission broad authority to prohibit all kinds of manipulative practices. An earlier version of Section 10(b) (Section 9(c) of H.R. 8720, 73d Cong., 2d Sess. (1934)), which had substantially the same language, was described to the House Committee considering the Act as "a catchall clause to prevent manipulative devices." [6] Indeed, representatives of the securities industry repeatedly objected to this provision on the grounds that it would authorize the Commission to prohibit virtually anything.[7]

The argument of petitioner and the AICPA essentially is that Section 10(b) should be limited to the common-law tests of fraud, misrepresentation or deceit. This Court has frequently rejected attempts to give the remedial provisions of the federal securities legislation such a restricted interpretation. In *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, the Court stated:

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[4] Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6509 (1934) ("Senate Hearings").

[5] *Id.* at 6510.

[6] Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) ("House Hearings").

[7] House Hearings at 178, 208-209, 251, 258, 297, 305, 486; Senate Hearings at 6624-6625, 6634, 6899, 6910, 6938, 6988, 7562.

> the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as * * * securities, and * * * accordingly, the doctrines must be adapted to the merchandise in issue.

Only last Term this Court pointed out in the *Blue Chip* case (slip op. at p. 21) that "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which" Section 10(b) and Rule 10b-5 are applicable.

In short, the use of the words "manipulative or deceptive" in Section 10(b) does not indicate, as petitioner and the AICPA contend (Pet. Br. 36-39; AICPA Br. 11-12), and as some judges have suggested,[8] that Congress intended the prohibitions of that section to cover only intentional conduct. Those words refer not to the state of mind of the actor but to the effect of his conduct.

B. Rule 10b-5 Supports a Private Action Against an Accountant Based upon the Negligent Performance of His Work

1. Acting pursuant to its rule-making authority under Section 10(b), the Commission in 1948 adopted

[8] *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (C.A. 2) (Judge Friendly, concurring), certiorari denied *sub nom. Kline* v. *Securities and Exchange Commission*, 394 U.S. 976; *Kohn* v. *American Metal Climax*, 458 F.2d 255, 280 (C.A. 3) (Judge Adams, concurring and dissenting). See, also, Loss, *Summary Remarks*, 30 Business Lawyer 163, 165 (1975).

Rule 10b-5 (17 C.F.R. 240.10b-5), which makes it unlawful for any person, "in connection with the purchase or sale of any security,"

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person * * *.

These broad prohibitions, like the broad language of the underlying statute, prohibit negligent as well as intentional conduct. At least with respect to omission of material facts that are necessary to make statements not misleading and an act, practice or course of business which "operates or would operate as a fraud or deceit upon any person," the ban of Rule 10b-5 goes beyond common-law fraud and on its face covers negligent omissions and commissions. This reading of the rule is necessary to accomplish its purpose of protecting investors, who are victimized equally by conduct, whether negligent or intentional, which operates as a fraud and deceit upon them.[9]

[9] While the Commission's release announcing the adoption of Rule 10b-5 simply stated that the rule was intended to prohibit "individuals or companies from buying securities if they engage in fraud in their purchase," SEC Securities Exchange Act Release No. 3230 (May 21, 1942), the rule was modeled after Section 17(a) of the Securities Act of 1933,

This interpretation of the rule is confirmed by the substantial number of decisions recognizing that, in a suit by the Commission to enjoin violations of Rule 10b-5, the agency proves a violation of the rule by showing that conduct contravening the substantive standards of the rule was done negligently.[10] Petitioner (Br. 46-47) and the AICPA (Br. 32) apparently accept this principle, but seek to limit it to Commission injunctive actions.

The question whether negligent conduct may violate Rule 10b-5, however, cannot and does not de-

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15 U.S.C. 77q(a). Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Business Lawyer 793, 922 (1967). Section 17(a), in turn, was based at least in part on New York's Martin Act, which prohibits conduct by corporations and their officers and directors which operates as a fraud, regardless of whether the acts were intentional. See *People* v. *Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655; *People* v. *Photocolor Corp.*, 156 Misc. 47, 281 N.Y.S. 130. A contemporaneous comment on Section 17 stated that it "makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L. J. 171, 181 (1933)

[10] *Securities and Exchange Commission* v. *Management Dynamics, Inc.*, 515 F.2d 801 (C.A. 2); *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (C.A. 2); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra* (Judge Friendly, concurring). See, also, *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180; cf. Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562 (1972). *Securities and Exchange Commission* v. *Coffey*, 493 F.2d 1304, 1314 (C.A. 6), certiorari denied, 420 U.S. 908, which held that the Commission must show "wilful or reckless disregard for the truth" in order to obtain an injunction in an action brought under Rule 10b-5, is inconsistent with this line of authority and, we believe, erroneous.

pend upon the identity of the plaintiff. If negligent conduct violates the rule when the Commission sues, it necessarily also violates the rule when the suit is by a private party. Petitioner's and the AICPA's attempted distinction based upon the identity of the plaintiff ignores the crucial difference between the question of violation and the question of entitlement to damages or other relief. See *Rondeau* v. *Mosinee Paper Corp.*, No. 74-415, decided June 17, 1975, and the discussion in Point II, *infra*, pp. 23-33).[11]

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[11] Petitioner (Br. 44-45) and the AICPA (Br. 21-23) argue that because some of the provisions in the federal securities laws that expressly permit recovery of damages for negligent conduct also contain specific statutes of limitations and require security for costs, the absence of the two latter provisions in Rule 10b-5 shows that something more than negligence is required to recover damages for violation of that rule. This is a *non sequitur*. The question whether negligent conduct violates the rule is distinct from the issues respecting the conditions for maintaining an action based upon that violation, such as the governing statute of limitations, the need to post security for costs and the award of costs and attorneys' fees to successful defendants. Indeed, even though the courts of appeals disagree whether negligent conduct may establish damage liability under Rule 10b-5, every circuit that has considered the question has held that the governing period of limitations in such an action is that provided by state law for analogous suits. See, *e.g.*, *Wolf* v. *Frank*, 477 F.2d 467 (C.A. 5); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (C.A. 7); *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (C.A. 10); *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (C.A. 9); *Vanderboom* v. *Sexton*, 422 F.2d 1233 (C.A. 8), certiorari denied, 400 U.S. 852; *Charney* v. *Thomas*, 372 F.2d 97 (C.A. 6); *Janigan* v. *Taylor*, 344 F.2d 781 (C.A. 1), certiorari denied, 382 U.S. 879; *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (C.A. 2). Cf. *Newman* v. *Prior*, [Current] CCH Fed. Sec. L. Rep. ¶ 95,211 (C.A. 4).

2. The applicability of the prohibitions of Rule 10b-5 to negligent conduct is particularly important and appropriate in dealing with accountants. A central remedial policy of the federal securities laws, which the Commission's rules are designed to implement, is that companies must fully and accurately disclose their financial condition. A key element in accomplishing such disclosure is the accountant's review and certification of a company's financial statements.

Because of the critical role accountants play in insuring full disclosure, the Commission has repeatedly emphasized that in certifying financial statements required under the federal securities laws, the accountant's "duty is to safeguard the public interest, not that of his client." [12] As the court observed in *United States* v. *Benjamin*, 328 F.2d 854, 863 (C.A. 2), certiorari denied *sub nom. Howard* v. *United States*, 377 U.S. 953, "[i]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." See, also, *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535, 541-542 (C.A. 2), where in holding that the Commission might be entitled to an injunction under Section 10(b) against a lawyer who acted

[12] *In the Matter of Touche, Niven, Bailey & Smart*, 37 SEC 629, 670-671; see, also, *In the Matter of McKesson & Robbins, Inc.*, SEC Accounting Series Release No. 19, 5 CCH Fed. Sec. L. Rep. ¶ 72,020 (December 5, 1940); *In the Matter of Touche Ross & Co.*, SEC Accounting Series Release No. 153, 5 CCH Fed. Sec. L. Rep. ¶ 72,175 (February 25, 1974).

negligently in preparing an opinion letter on the basis of which unregistered securities were sold in violation of the federal securities laws, the court noted the "unique and pivotal role in the effective implementation of the securities laws" which "the legal profession plays." The *amicus* AICPA itself has recognized that

> [t]he reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence * * *.[13]

The possibility that accountants may be subjected to damage liability for negligent performance of their work, under the conditions we now discuss, would have a salutary and effective role in insuring that in performing that work they observe the highest

[13] American Institute of Certified Public Accountants, Preamble to the *Code of Professional Ethics* (1969) (p. 1).

The American Institute of Certified Public Accountants' *Restatement of the Code of Professional Ethics* (1972) states (p. 6):

> The reliance of the public, the government and the business community on sound financial reporting and advice on business affairs, and the importance of these matters to the economic and social aspects of life impose particular obligations on certified public accountants.
>
> * * * * *
>
> The ethical Code of the American Institute emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal and as government increasingly relies on accounting information.

professional standards.[14] Cf. *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2), where, in holding that negligent violations of the Commission's proxy rules would justify imposition of damage liability upon the violators, the court pointed out (478 F.2d at 1300) that "a broad standard of culpability * * * will serve to reinforce the high duty of care owed by a controlling corporation to minority shareholders in the preparation of a proxy statement seeking their acquiescence in this sort of transaction * * *."

3. Although Ernst & Ernst in the instant action is alleged only to have "aided and abetted Nay in his violation of the Rule [10b-5]" (App. 12), framing the complaint in this form should not alter the focus of the initial inquiry into whether Ernst & Ernst's negligent preparation and certification of First Securities' financial statements itself violated the rule. Rather than establishing the parameters of liability of certain defendants under the federal securities laws, the term "aider and abettor" has been recognized as serving as a convenient designation for those persons who "have contributingly played a part in the doing or commission" of a violation of those laws by another. See *Securities and Exchange Commission* v. *Barraco*, 438 F.2d 97, 100 (C.A. 10).

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[14] Accountants, like other professional experts, are required to make difficult judgments reflecting the current status of the learning of their profession. They should not be held to have performed their work negligently because their judgment, although honestly and conscientiously made, turns out on hindsight to have been mistaken.

In the present case Ernst & Ernst's conduct may have violated Rule 10b-5 even if their sole participation in Nay's violation was as an "aider and abettor". Initially, there is no question that Nay violated Rule 10b-5 by defrauding the respondents,[15] and that Nay's actions violated the federal securities laws independent of Ernst & Ernst's conduct. Thus, for purposes of determining whether Ernst & Ernst's own conduct violated Rule 10b-5, its alleged negligence in failing to report upon an alleged deficiency in First Securities system of internal controls would constitute a misstatement or an omission to state a material fact necessary to make the statements made not misleading in connection with Nay's and the respondents' respective sales and purchases of securities. Cf. *Superintendent of Insurance* v. *Bankers Life, supra.*

In addition, any requirement that aiders and abettors must have knowledge of the independent wrong committed by another[16] is satisfied when the aider and abettor has breached a duty of inquiry and would have acquired knowledge of the independent

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[15] See generally, *Securities and Exchange Commission* v. *First Securities Co. of Chicago*, 463 F.2d 981 (C.A. 7), certiorari denied *sub nom. McKy* v. *Hochfelder*, 409 U.S. 880.

[16] See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 630-638 (1972), and authorities cited therein.

wrong if the duty of inquiry had been fulfilled.[17] The court of appeals held that Ernst & Ernst had both a common law duty of inquiry resulting from its contractual arrangement with First Securities and a statutory duty of inquiry imposed by Section 17(a) of the Securities Exchange Act and Rule 17a-5 thereunder (Pet. App. 5a-6a). Assuming that Ernst & Ernst would have acquired knowledge of Nay's mail rule if it had fulfilled its duty of inquiry, the breach of that duty, whether negligent or willful, facilitated Nay's fraud.[18]

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[17] See ALI, *Restatement of Torts*, § 876(c) (1939) which provides:

> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
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> * * * * *
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

See also Ruder, *Aiding and Abetting*, 7 Review of Securities Regulation 882 (1974).

[18] If Ernst & Ernst failed to disclose relevant facts to the regulatory authorities in its certification of First Securities' financial condition, the presumption is that appropriate regulatory action would have been taken had the disclosure been made. See *Brennan* v. *Midwestern United Life Insurance Co.*, 417 F.2d 147, 154 (C.A. 7), certiorari denied, 397 U.S. 989.

II. AN ACCOUNTANT WHO VIOLATES SECTION 10(b) AND RULE 10b-5 BY NEGLIGENTLY PREPARING A FALSE OR MISLEADING FINANCIAL STATEMENT IS LIABLE IN DAMAGES TO THIRD PERSONS ONLY IF (1) HE KNEW OR COULD REASONABLY FORESEE THAT HIS STATEMENT WOULD INDUCE THE PLAINTIFF TO ENTER INTO THE PARTICULAR TRANSACTION WHICH FORMS THE BASIS OF THE SUIT, (2) THE PLAINTIFF RELIED UPON THE STATEMENT, AND (3) THE AMOUNT OF THE PLAINTIFF'S DAMAGES CAUSED BY THE ACCOUNTANT'S NEGLIGENCE IS DEFINITE AND ASCERTAINABLE

The conclusion that negligent conduct may violate Section 10(b) and Rule 10b-5 does not end the inquiry in this case. There remains the further question of the circumstances under which a person who has suffered damage as a consequence of such negligence may recover damages from the negligent actor. "[T]he questions of liability and relief are separate in private actions under the Securities Laws, and * * * the latter is to be determined according to traditional principles" (*Rondeau* v. *Mosinee Paper Corp.*, *supra*, slip op. at p. 15; see, also, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386). More specifically, the question is what further showing a plaintiff must make before he can recover damages from an accountant who has negligently violated Rule 10b-5.

Since the private right of action for violation of Section 10(b) and Rule 10b-5 is a judicially created, rather than a congressionally formulated, remedy, the "cause of action * * * will have to be judicially delimited one way or another unless and until

Congress addresses the question" (*Blue Chip*, *supra*, slip op. at p. 25). Congress, however, has furnished guidance for the formulation of appropriate rules governing this judicially-created remedy in its approach to liability in those sections of the federal securities acts which specifically provide for private damage suits. Since the theory of the implied private right of action under the federal securities laws is that it is necessary to effectuate the congressional standards for the conduct of securities transactions, the standards Congress adopted when it expressly created private actions under those laws are an appropriate guideline in defining the contours and conditions of the judicially-created right of action. As the Court stated in *Blue Chip* (slip op. at p. 12), it would be "anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

Although the conditions under which Congress has explicitly permitted recovery of damages for violations of various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 vary, they have a common thread. The differing circumstances governing the recovery of such damages basically reflect (1) the degree to which the defendant knew or had reason to believe that the victims of the violation would rely upon or be influenced by his conduct, (2) the degree to which the victims in fact did so rely or were so influenced, and (3) the definiteness and ascertainability of the damages caused by

the illegal conduct. Thus, Congress has made the extent of liability imposed upon a participant in a securities transaction dependent upon the culpability of the unlawful conduct and the relationship between the defendant and the transaction that resulted in the plaintiff's injury. The more direct the relationship, the lesser the culpability required for liability.

There are three provisions of the federal securities laws in which Congress provided absolute liability in damages for violation of those laws. Section 12(1) of the Securities Act of 1933, 15 U.S.C. 77*l*(1), makes any person who sells an unregistered security in violation of the registration requirements of Section 5 of that Act liable to the purchaser of such security for the amount paid, less any income received thereon. In Section 11 of that Act, 15 U.S.C. 77k, Congress imposed similar liability upon the issuer of a security distributed pursuant to a false or misleading registration statement. Finally, in Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), corporate insiders who purchase and sell their corporation's securities within six months must remit to the corporation all profits made on such transactions, without regard to whether they relied upon any inside information.

In the other provisions of the federal securities laws that expressly provide for private damage suits, however, Congress has limited the right of recovery in a way that reflects the three considerations noted above.

In connection with a public distribution of securities pursuant to a false or misleading registration statement, persons who signed the registration statement (other than the issuer) and experts, including accountants, whose certificates, reports or opinions are included in the registration statement, are not liable under Section 11(b)(3) of the Securities Act of 1933, 15 U.S.C. 77k(b)(3), if they show that, after making a reasonable investigation, they had reasonable grounds to and did believe that the registration statement was correct. In formulating this provision, which went beyond the common law of fraud,[19] Congress considered whether to impose absolute liability upon all persons who signed or played a significant role in connection with the registration statement, or to limit liability to persons who had acted intentionally or negligently.[20] Congress concluded to restrict absolute liability to the issuer but to subject the other participants in the securities distribution to "a duty of care to discover" untrue statements and omissions in registration statements, which would result in that "degree of protection [in registered distributions] that the public has a right to expect." [21]

In Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2), Congress provided that a seller of securities

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[19] See Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227 (1933).

[20] See H.R. Rep. No. 85, 73d Cong., 1st Sess. 3, 9 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 4-6 (1933).

[21] H.R. Rep. No. 85, *supra*, at 9.

who could show that he did not know, and in the exercise of reasonable care could not have known, of any untruth or omission made in connection with the offer and sale of a security, would not be liable to a person who purchased from him in reliance on that untruth or omission. In Section 15 of the Act, 15 U.S.C. 77*o*, Congress similarly provided that persons who control other persons liable under Sections 11 and 12 would not be liable if they proved that they had no knowledge of the untruth or omission and had no reasonable ground to believe that it existed.

The civil liability provisions of the Securities Exchange Act of 1934 also demonstrate Congress' concern with imposing carefully drawn limitations upon the right to recover damages for violations of that Act. As previously noted, Section 9(e) of that Act, 15 U.S.C. 78i(e), which prohibits manipulation of security prices, provides for monetary liability only against one "who willfully participates in any act or transaction" that violates the section. Section 20(a) of the Act, 15 U.S.C. 78t(a), provides that persons controlling other persons who incur civil liability under the Act shall be jointly and severally liable to the same extent as the controlled person "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Finally, Section 18(a) of the Act, 15 U.S.C. 78r(a), provides that persons who have filed false and misleading statements with the Commission "shall be liable to any

person (not knowing that such statement was false or misleading) who, in reliance upon such statement shall have purchased or sold a security at a price which was affected by such statement," unless the person who filed the statement proves that the statement was made "in good faith" and without "knowledge that such statement was false or misleading."

The statutory provisions for damage suits thus contain three standards of liability. (1) A narrow class of persons—those who are the primary participants in the securities transactions, such as the sellers of unregistered securities and the issuers of securities pursuant to a misleading registration statement—are subjected to absolute liability. (2) A larger group, consisting of persons who are responsible for representations made in effecting a particular stock distribution or whose conduct is specifically intended to influence a particular transaction, are respectively liable only if they fail to make a reasonable investigation to ascertain the correctness of the distributed material (Section 11 of the Securities Act) or if they act negligently (Section 12(2) and 15 of the Securities Act), and only to a limited class of plaintiffs. Finally, under Sections 18(a) and 20(a) of the Securities Exchange Act misstatements filed with the Commission create liability to persons who purchased or sold a security in reliance upon the statement—a broader and less readily ascertainable category than the two others—only if the acts were

done not in good faith or with knowledge of the falsity.[22]

In *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2), the court recognized the appropriateness of applying different standards of damage liability reflecting the extent to which the violation of the federal securities laws was directly related to the plaintiffs. The court held that damage liability for issuing a misleading proxy statement in violation of the Commission's proxy rules under Section 14 of the Securities Exchange Act of 1934 could be predicated on negligence and that the plaintiffs "are not required to establish any evil motive or even reckless disregard of the facts" (478 F.2d at 1301). In rejecting the contention that imposing liability for negligent violations of the proxy rules would be inconsistent with Section 18 of the Act, under which there is lia-

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[22] The legislative history of Sections 18(a) and 20(a) suggests that these sections require a plaintiff to show that the defendant acted with something more than negligence. For instance, the original version of Section 18(a), Section 17(a) of H.R. 7852, 73d Cong., 2d Sess. (1934); H.R. 7855, 73d Cong., 2d Sess (1934); and S. 2693, 73d Cong., 2d Sess. (1934), provided that a defendant would not be liable if

> he acted in good faith and in the exercise of reasonable care had no ground to believe that such statement was false or misleading.

The accounting profession objected to this provision on the ground that it would result in liability for honest errors of judgment. See House Hearings at 653; Senate Hearings at 7175-7183. In subsequent drafts the standard was changed to its present formulation imposing liability only where the defendant acted without good faith and with knowledge of the misstatement.

bility only if the defendant acted without good faith and with knowledge of the misstatement (see *supra*, pp. 28-29), the court stated (478 F.2d at 1299-1300, n. 18):

> [S]ection 18 applies broadly to any document filed with the Commission, whereas section 14 was specifically directed at proxy regulation. Moreover, most of the documents within the scope of section 18 are not distributed to stockholders for the purpose of inducing action; we see nothing anomalous about applying a different standard of culpability in actions concerning misrepresentations in proxy statements which are so distributed than in those involving reports which were merely filed with the Commission.

The court also noted that, unlike other sections of the federal securities laws, which require knowledge for liability in situations where there may be no privity between the plaintiff and defendant, "liability" for violation of the proxy rules "is limited to the stockholders whose proxies were solicited" (*id.* at 1300).

In addition to indicating the nature of the conduct which may result in liability by a particular defendant, the express civil remedies in the federal securities laws also illustrate Congress' concern that liability for damages should reflect the relation between the plaintiff's injury and the extent to which that injury may have been caused by the defendant's conduct. Section 11(e) of the Securities Act, 15 U.S.C. 77k(e), provides that a defendant otherwise liable may reduce or eliminate his liability to the plaintiff to the extent that the plaintiff's loss "represents other than the depreciation in value of such security resulting from [the false or misleading] part of the registration statement, with respect to which [the defendant's] liability is asserted." Similarly, in Section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78r(a), the defendant's liability is limited by the extent to which the false or misleading statement relied upon by the plaintiff affected the price at which the plaintiff purchased or sold the security.

When information is furnished to, or withheld from, shareholders or the investing public for the purpose of inducing a particular transaction, it is appropriate to subject the persons responsible for that conduct to damage liability for negligent as well as intentional action. On the other hand, when information is disseminated to the public generally, outside the context of a particular transaction, something more is required before damages may be recovered when the defendant's violation of Rule 10b-5 is merely negligent. To conclude otherwise, as Chief Judge Cardozo observed in another case involving the alleged negligence of accountants, would result in "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444; cf. *Leasco Data Proc. Equipment Corp.* v. *Maxwell*, 468 F.2d 1326, 1341-1342 (C.A. 2).

This approach to determining damage liability under Rule 10b-5 will strike an appropriate balance between the right of investors to receive complete and accurate information and the need to avoid unfairness to a particular defendant by subjecting him to substantial liability for all sorts of negligent conduct.

Applying these principles to damage actions under Section 10(b) and Rule 10b-5, recovery of damages for reckless, willful or intentional violations of the rule should be permitted upon a showing that such violations injured the plaintiff. Where, however, the violation was committed only negligently, the defendant should be liable only if the relationship between the plaintiff and the defendant is such that (1) the latter knew or had reason to believe that the plaintiff would rely upon his conduct, (2) the plaintiff in fact did so rely, and (3) the amount of the plaintiff's damages resulting from the defendant's negligent violation is definite and ascertainable.[23] As we

[23] In *Blue Chip, supra,* the Court, in holding that persons who had neither purchased nor sold securities could not maintain an action for damages under Rule 10b-5 (the *Birnbaum* rule), stated (slip op. at pp. 31-32):

> * * * a shifting and highly fact-oriented disposition of the issue of who may bring a damage claim for violation of Rule 10b-5 is [not] a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

That statement, however, dealt with deliniation of the categories of persons who could bring suit under Rule 10b-5 and not, as in the present case, with the basis upon which liability may be established under that rule. It was made in the context of choosing between an interpretation of Rule 10b-5 (the *Birnbaum* rule) that would limit "vexatious litigation" (*id.* at pp. 16-20) and one that left the "*Birnbaum* rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs were thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception" (*id.* at p. 31).

Unlike the threshold issue of standing in *Blue Chip,* the determination of liability necessarily depends upon "a shifting and highly fact-oriented disposition" of the particular case. In the present case, the determination whether Ernst & Ernst was negligent necessarily depends upon the particular facts; but in virtually every suit under Rule 10b-5 a factual inquiry will be necessary to determine whether the defendant engaged in manipulative or deceptive practices.

In short the basis of liability for negligent violations of Rule 10b-5 is not reasonably susceptible to the kind of absolute rule applied in *Blue Chip.* Rather, it requires consideration in the individual case of the relationship between the plaintiff and defendant, viewed in the context of the policies of the Securities Exchange Act of 1934.

now show, under respondents' complaints and the present record in this case, none of these conditions is satisfied, much less all of them.

III. NEITHER RESPONDENTS' COMPLAINTS NOR THE PRESENT RECORD IN THIS CASE INDICATE THAT RESPONDENTS ARE ENTITLED TO RECOVER DAMAGES FROM ERNST & ERNST

As discussed above, the degree of culpability necessary to subject an accountant to liability for damages in a private action under Rule 10b-5 depends, in the first instance, on the relationship between the accountant and the plaintiff in the transaction which violated Rule 10b-5. There is no question that Nay

violated Rule 10b-5 by defrauding the plaintiffs. See *supra*, p. 21. The present issue is whether Ernst & Ernst can be subjected to damages to respondents if it violated Rule 10b-5 by negligently auditing First Securities.

If, under generally accepted auditing standards and generally accepted accounting principles, Ernst & Ernst was negligent in its audit of First Securities by failing to discover and disclose Nay's mail rule, then it violated Rule 10b-5, since its negligence resulted in the misstatement or omission of a material fact regarding First Securities' financial condition: the inadequacy of its system of internal controls. Respondents allege that such a violation of Rule 10b-5 by Ernst & Ernst effectively concealed Nay's fraudulent scheme from regulatory authorities, including the Commission, and thus indirectly allowed Nay to perpetrate a fraud upon his escrow customers in connection with the purchase and sale of securities.

As the court of appeals noted, however, Ernst & Ernst's certification of First Securities' financial condition was not relied upon by respondents, who were customers of Nay rather than of First Securities insofar as they invested in the escrow account.[24] Rather, that certification at most facilitated Nay's concealment of his fraudulent activity, and thus

[24] Although respondents' complaints alleged that they were customers of First Securities (App. 3), they were not customers of that firm in connection with their investments in Nays' escrows. *Securities and Exchange Commission* v. *First Securities Co. of Chicago*, 507 F.2d 417, 421 (C.A. 7).

avoided detection and correction by regulatory authority. Furthermore, there is no allegation that Ernst & Ernst even suspected the existence of the spurious escrow accounts, or respondents' interests therein.

In view of the lack of any nexus between respondents and Ernst & Ernst, under the principles discussed above respondents have not established that Ernst & Ernst is liable to them for a negligent violation of Rule 10b-5. Respondents did not rely either directly or indirectly on Ernst & Ernst's audits;[25] the financial statement of First Securities could not

[25] The court of appeals concluded that, despite respondents' admitted nonreliance, they nevertheless might recover on the theory that (1) Ernst & Ernst was required by Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-5 to conduct its audit "in accordance with generally accepted auditing standards," which included the duty "to investigate F[i]rst Securities' system of internal accounting controls" (Pet. App. 11a, 13a), and (2) Ernst & Ernst's breach of is statutory duty to conduct a proper audit "inured to the benefit of [respondents]" because "the extant duty of inquiry imposed on Ernst & Ernst is grounded on a concern for the protection of investors such as the [respondents]" (Pet. App. 6a). But even assuming the correctness of these propositions, respondents still have not stated a valid claim for damages against Ernst & Ernst.

In conducting its audit of First Securities, any statutory duty Ernst & Ernst had ran only to the customers of that firm, since the provisions of the Securities Exchange Act of 1934 governing the audits of broker-dealers are designed to protect customers of those firms. In investing in Nay's spurious escrow account, however, respondents were customers not of First Securities but of Nay (n. 24, p. 34), since the escrow accounts were not a part of First Securities' business but a separate venture that Nay personally conducted.

have been reasonably foreseen as likely to induce respondents to invest in Nay's escrows, of which Ernst & Ernst was not even aware; Ernst & Ernst could not have reasonably anticipated the damages to respondents.

If the Court agrees with this analysis, the normal disposition of this case would be to reverse the court of appeals' judgment reversing the district court's grant of summary judgment in favor of Ernst & Ernst, and thus reinstate that judgment. The principles we here urge, however, were not presented in the lower courts. If they had been, respondents might have presented their case on a different basis. Moreover, respondents' answers to interrogatories suggest that respondents may contend that in auditing First Securities, Ernst & Ernst was more culpable than merely performing its work negligently, *i.e.*, the alleged deficiencies in the audit may have resulted from intentional or reckless conduct (App. 81; see also, brief of respondents Olga Hochfelder, *et al.*, at 12-14).

If that is respondents' contention, the district court might permit them to amend their complaint to reflect that theory. In the circumstances, it would be appropriate to modify the court of appeals' judgment to require that the further proceedings on remand be in accordance with the principles set forth in this brief.

CONCLUSION

The judgment of the court of appeals should be modified to require that the proceedings in the district court on remand be in accordance with the principles set forth in this brief and, as thus modified, the judgment should be affirmed.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

DANIEL M. FRIEDMAN,
Deputy Solicitor General.

LAWRENCE E. NERHEIM,
General Counsel,

PAUL GONSON,
Associate General Counsel,

CHARLES E. H. LUEDDE,
Special Counsel,

THEODORE L. FREEDMAN,
JOHN M. MAHONEY,
Attorneys,
Securities and Exchange Commission.

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